IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

No. 93

W. G. CHOATE, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit

BRIEF FOR THE PETITIONER

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Opinions Below

The Memorandum Opinion of The Tax Court (R. 13), is unreported. The opinion of the Circuit Court of Appeals for the Tenth Circuit (R. 43), is reported at 141 Fed. (2d) 641.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered March 13, 1944 (R. 47). A petition for rehearing was filed April 3, 1944 (R. 47), and denied April 8, 1944 (R. 53). A petition for a writ of certiorari was filed May 23, 1944, and granted October 9, 1944, limited to the second question presented by the petition for the writ (R. 54). The jurisdiction of this Court is conferred by Section 240(a) of the JUDICIAL CODE as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where title to the depreciable equipment on an oil and gas lease passed to the assignee absolutely without any interest therein being reserved to the assignor, is the unrecovered cost of the equipment deductible from the cash consideration in computing the gain, or must it be recovered through depletion allowances applicable to production from the retained interest in the oil reserves?

Statutes and Regulations Involved

The statutes and regulations involved will be found in the Appendix hereof (p. 21).

Statement

The petitioner was a member of a partnership which owned and operated an oil and gas lease on lands situated in the State of Texas, on which there were six producing oil wells. On October 11, 1938, the partnership contracted to sell the lease, together with all of the leasehold equipment to McAlester Fuel Company for a cash consideration of $110,000, with the sellers excepting and reserving to themselves, their heirs and assigns, an overriding royalty of 1 8th of 8/8ths of all oil and gas produced and saved by the buyer (R. 36). On August 22, 1938, the partnership assigned the lease, together with all of the equipment thereon to the Sylva Oil Company (nominee of McAlester Fuel Company), reserving to themselves 1/8th of 8 8ths of all the oil and gas produced, as provided in the contract of October 11. The sellers reserved no interest in the well equipment or other personal property that was on the lease at the time of the sale, and all their right, title and interest therein passed to the buyer

by virtue of the terms of the assignment (R. p. 8). The respondent allowed the Sylva Oil Company to deduct depreciation on the equipment after it was assigned to that company.[1]

In the return filed by the partnership for the year 1938, the profit from the sale of the interest in the lease was reported as long-term capital gain and the loss on the sale of the equipment as a short-term loss (Sec. 117 of the REVENUE ACT of 1938), as follows:

	Leasehold	Equipment	Total
Sale Price . . .	$98,454.70	$11,545.30	$110,000.00
Less Cost of Sale:			
Gross Cost . .	$33,391.80	$30,206.49	$ 63,598.29
Less—Reserves for Depletion and Depreciation . .	9,808.02	7,115.89	16,923.91
Net Cost of Sale .	$23,583.70	$23,090.60	$ 46,674.38
Gross Gain from Sale	$74,870.92	($11,545.30)	$ 63,325.62
Less Commission Paid	3,000.00		3,000.00
Net Gain from Sale	$71,870.92	($11,545.30)	$ 60,325.62
Taxable Gain from Sale (Sec. 117, Revenue Act of 1938) . . .	$47,913.95	($11,545.30)	$ 36,368.65

The respondent held that the transaction constituted a

[1] It (Sylva Oil Co.) claimed depreciation on the cost thus allocated to equipment in its return for the year 1938 in the amount of $1,671.17, and in its income tax return for 1939 in the amount of $5,613.35 which amounts were allowed to it for those years as depreciation on the equipment by the Commissioner of Internal Revenue after an examination by his agent (Findings of Fact Tax Court, R. 18).

sublease rather than a sale of a capital asset, and he computed the profit as follows:

"Oil Income" . . .		$110,000.00
Less—Depletion . . .	$30,250.00	
Less—Commission . .	3,000.00	33,250.00
Net Income		$ 76,750.00

Respondent, however, made no allowance for the undepreciated cost of the equipment that was on the lease at the time of sale, and held that such cost was recoverable through depletion allowances applicable to production from the retained interest of 1/8th of 8/8ths (R. 20).

In the proceeding in The Tax Court, the petitioner contended that the transaction constituted a sale of a capital asset, but plead in the alternative that if The Tax Court determined that the transaction was not a sale in so far as the leasehold itself was concerned, that the partnership parted with all of its right, title and interest in the equipment and was entitled to have the undepreciated cost of the equipment ($23,090.60), deducted from the cash consideration of $110,000 in determining the gain.

The Tax Court held, (1) that the partnership was not entitled to treat the transfer of the interest in the lease as a sale, but must look to depletion for the return of its capital; and (2) that the unrecovered cost of the equipment on the lease at the time of the transfer is deductible in full from the cash consideration in determining the amount of gain subject to the depletion allowance (R. 13). Both the petitioner and the Commissioner appealed to the Tenth Circuit Court of Appeals and that court sustained the holding of The Tax Court that the transfer of the interest in the lease could not be treated as a sale due to the fact that an overriding royalty was retained by the sellers, but reversed The

Tax Court on the issue relating to the equipment. Said court held that the cost of the equipment must be recovered through percentage depletion applicable to the proceeds from the retained royalty. In the companion case of FRED T. HOGAN v. COMMISSIONER and COMMISSIONER v. FRED T. HOGAN, 141 Fed. (2d) 92 (Hogan was one of the partners), the Fifth Circuit Court of Appeals affirmed the decision of The Tax Court on both points (App. p. 26).

Petitions for writs of certiorari were duly filed in this Court by the petitioner and Fred T. Hogan and this Court was asked to pass on both of the questions involved in The Tax Court proceedings. This Court granted the writ in the instant case, but limited it to the question of whether or not the undepreciated cost of the equipment on the lease at the time of sale is to be deducted from the cash consideration in determining the gain, or whether such cost is to be recovered through depletion allowances applicable to the retained interest.

Summary of the Argument

1. The Tenth Circuit rested its decision on the decision of the Fifth Circuit in CULLEN v. COMMISSIONER, infra. The Fifth Circuit repudiated and reversed its decision in the CULLEN case in HOGAN v. COMMISSIONER, supra. Accordingly the CULLEN decision is no authority for the holding of the Tenth Circuit.

2. The lease and the equipment in the instant case were no more sold as a unit than was the lease and equipment in the case of LEWIS v. COMMISSIONER, infra. Hence, there is no valid distinction between the two cases and the Tenth Circuit should have followed its LEWIS case decision herein.

3. The cost of the equipment cannot be returned to pe-

titioner through either percentage or cost depletion. The cost can only be returned to him by deducting it from the cash consideration, and if this is done it will not constitute a double deduction. The effect of the decision of the Tenth Circuit is to tax petitioner with the cost of his equipment.

4. Under the law and regulations there are only two ways by which the cost of the equipment of an oil and gas lease can be recovered. The first is by way of an offset against the selling price when the property is sold, and the second is through annual depreciation allowances where the property is kept and operated. There is no authority for recovering equipment cost through depletion, either by the percentage of income method or on the cost basis.

5. There is no valid distinction between an oil payment and overriding royalty and the same tax effect should be given to each. The courts have uniformly held that the cost of the equipment is deductible in full from the consideration where the lease is sold for cash and an oil payment. The same rule should be applied where the sale is for cash and an overriding royalty.

6. An oil and gas lease and the equipment thereon are, for income tax purposes, different classes of property. One is depletable; the other depreciable. The cost of each is recoverable by different processes. The cost of depreciable equipment may not be transformed into the cost of the leasehold and recovered through depletion.

7. The partnership sold the equipment outright. It retained no interest or lien of any kind. The Commissioner recognized that ownership of the equipment was in Sylva because he allowed that company to take depreciation on it. The undepreciated cost of the equipment is, therefore, deductible from the consideration in computing the gain on the transaction.

Argument

The Tenth Circuit rested its decision on the decision of the Fifth Circuit in Cullen v. Commissioner, infra. The Fifth Circuit repudiated and reversed its decision in the Cullen case in Hogan v. Commissioner, infra. Accordingly, the Cullen decision is no authority for the holding of the Tenth Circuit.

1. The Circuit Court of Appeals for the Tenth Circuit held that since the lease and the equipment were sold as a unit without any segregation of the consideration being made as between the leasehold and the equipment, the cost of the latter is recoverable through percentage depletion allowances (Sec. 114(b)(3), App. p. 21), and may not be deducted from the cash consideration in computing the gain. Both the Commissioner and the Tenth Circuit Court of Appeals relied on the statement made by the Fifth Circuit Court of Appeals in its decision in CULLEN v. COMMISSIONER, 118 Fed. (2d) 651 (April 1, 1941), that the cost of the equipment on the nine leases with respect to which overriding royalties were retained was recoverable "by percentage depletion allowances." The Fifth Circuit Court of Appeals repudiated and reversed this holding in the case of HOGAN v. COMMISSIONER, 141 Fed. (2d) 92 (Feb. 25, 1944), where it said (in speaking of the equipment involved in the instant case), "equipment cost is recoverable through depreciation allowances and not 'by percentage depletion allowances,' as apparently was inadvertently stated in Cullen v. Commissioner, supra" (App. p. 32). Accordingly, the decision in CULLEN'S case is no authority for the holding of the Tenth Circuit herein.

The lease and the equipment in the instant case were no more sold as a unit than was the lease and equipment in the case of Lewis v. Commissioner, infra. Hence, there is no valid distinction between the two cases and the Tenth Circuit should have followed its Lewis case decision herein.

2. The Tenth Circuit Court of Appeals attempted to distinguish the instant case from its decision in COMMISSIONER v. LEWIS, 132 Fed. (2d) 709 (wherein it held that all of the cost of the equipment was deductible from the cash consideration), on the ground that here the transaction was one in entirety, covering both the oil reserves and equipment; whereas in the LEWIS case, it contends that the equipment was sold separately from the oil reserves. A portion of the facts found by The Tax Court in the LEWIS case are set out in the margin.[2]

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[2] In 1935 the partnership purchased two non-producing oil and gas leases for a total consideration of $120. Upon these leases the partnership placed certain equipment for the production of oil. On March 23, 1937, the partnership sold the two leases for a cash consideration of $150,000 and an oil payment of $125,000, payable out of one-fourth of seven-eighths of any oil produced from the leases. The contract provided in part as follows:

> "4. IT IS FURTHER UNDERSTOOD AND AGREED that for the consideration above named, said Second Party (vendee) shall be entitled to all of the material now in the ground on said aforedescribed premises, as well as the derricks over the wells now producing, or in the course of drilling on said aforedescribed premises, together with the lead-lines, well-head connections, tank battery, separators, and water wells now situated on said aforedescribed premises (Memo Opinion Tax Court, C.C.H. Dec. No. 12257-C).

It will be seen from The Tax Court's findings that the consideration was not segregated as between the leasehold and the equipment, but that for the $150,000 in cash and $125,000 payable out of oil, the partnership sold both the leasehold and the equipment. In the present case, the partnership assigned "all of its right, title and interest in the lease, * * * together with all wells and equipment thereof, including pumps, casing, pipes, tanks, lease house, et cetera." The granting clause of the assignment is set forth in the footnote 3. If the words "for the consideration above named" in the Lewis assignment are substituted for the word "together" in the Choate and Hogan assignment, the instruments would be substantially identical. This at most is a difference in verbiage and we submit that the lease and equipment in the instant case was no more sold as a unit than was the lease and equipment in the LEWIS case, and we believe that no valid distinction exists between the two cases. Accordingly, the Tenth Circuit should have followed its LEWIS case decision herein.

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3. "Now, therefore, for and in consideration of One Dollar ($1.00) and other good and valuable considerations, the receipt of which is hereby acknowledged, the undersigned L. H. Choate and Fred T. Hogan, the present owners of said lease, as hereinabove set out, and all rights thereunder or incident thereto down to the depth of 2750 feet, * * do hereby bargain, sell, assign and convey, subject to all of the terms and conditions, and the reservation of 1/16th overriding royalty in said assignment from Continental Oil Company to Roy R. Brown, all right, title and interest of the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, * * * together with all wells and the equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage to Sylva Oil Company, a Texas corporation, its successors and assigns; * * *"

The cost of the equipment cannot be returned to petitioner through either percentage or cost depletion. The cost can only be returned to him by deducting it from the cash consideration, and if this is done it will not constitute a double deduction. The effect of the decision of the Tenth Circuit is to tax petitioner with the cost of his equipment.

3. The allowance for depletion under Section 114(b)(3) (App. p. 21) is arbitrarily fixed at 27½% of gross income from the property not to exceed 50% of the net (Regs. 101, Art. 23(m)-1(g), App. p. 21). Percentage depletion is allowable whether the owner of the oil producing property has any cost or basis for it or not. Regardless of whether petitioner has any cost for his interest in the retained ⅛th overriding royalty, he will be entitled to 27½% depletion on the gross proceeds from the sale of his share of the oil runs. This percentage will not in anywise be increased by his share of the cost of the equipment and he will never have any of such cost returned to him through the operation of that subsection. He will likewise not receive any return on his capital investment in the equipment through cost depletion for the reason that under the law (Sec. 114(b)(1) and 113(a) and (a)(14), App. p. 22), and the Regulations (Regs. 101, Art. 23(m)-2 and (m)-16, App. pp. 22-23), only the cost or March 1, 1913, value of the lease or property plus the intangible costs of boring the well (if the taxpayer has elected to capitalize intangible development costs) is recoverable through depletion. Consequently, petitioner's share of the cost of the equipment on the lease cannot be added to the cost of his interest in the retained overriding royalty and recovered through depletion. The only way petitioner can have his share of the cost of the equipment returned

to him is by deducting it from the consideration received from the sale of the property. And, for the reasons above stated, if this is done, he will not receive anything akin to a double deduction. The effect of the decision of the Tenth Circuit is to tax petitioner on the cost of his equipment.

Under the law and regulations there are only two ways by which the cost of the equipment of an oil and gas lease can be recovered. The first is by way of an offset against the selling price when the property is sold and the second is through annual depreciation allowances where the property is kept and operated. There is no authority for recovering equipment cost through depletion, either on the percentage or cost basis.

4. Section 111 of the REVENUE ACT OF 1938 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis which includes cost (App. p. 25). Section 23(m) of the REVENUE ACT OF 1938 (App. p. 25) provides that in the case of mines, oil and gas wells, et cetera, there shall be allowed a reasonable amount for depletion and for depreciation of improvements. Art. 23(m)-18, REGULATIONS 101 (App. p. 25), provides that taxpayers operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion, as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes," et cetera.

Thus it will be seen the law and regulations provide only two methods of returning the cost of the equipment on an oil and gas lease. One is by way of offset against the selling

price when the equipment is disposed of; and the other by way of annual allowances for depreciation as long as the property is retained. There is not now, and never has been, any authority, either in the law or the regulations for returning the cost of the physical equipment of an oil well by way of depletion allowances, and there is no basis in the law or the regulations for the holding of the Tenth Circuit Court of Appeals that the cost of petitioner's equipment is recoverable by percentage depletion allowances.

There is no valid distinction between an oil payment and an overriding royalty and the same tax effect should be given to each. The courts have uniformly held that the cost of the equipment is deductible in full from the consideration where the lease is sold for cash and an oil payment. The same rule should be applied where the sale is for cash and an overriding royalty.

5. It is well established that oil payments and oil royalties are properties of like kind and character. The only difference between the two is that the oil payment is limited in amount, whereas the royalty continues as long as the property produces oil in paying quantities. This is merely a difference in degree or quantity. See STATE, ET AL., v. QUINTANA PETROLEUM CO. (Texas Sup. Ct.), 133 S.W. (2d) 112, and SHEPPARD v. STANOLIND OIL & GAS CO., 125 S.W. (2d) 643 (writ of error refused), in the latter of which the court said:

> "The oil bonus (payment), as we have seen partakes in every particular of the nature of royalty and royalty bonus, except only that its amount is limited. It is analogous to an overriding royalty. *And such it would in fact be if, instead of moving to the lessor, it moved to the lessee under an assignment of the lease.*"

The courts have uniformly held that where an oil and gas lease is sold for cash and an oil payment that the cost of the equipment is deductible in full from the cash consideration and that none of it is apportionable to the reserved oil payment interest. See LEWIS v. COMMISSIONER, supra (Tenth Circuit); COMMISSIONER v. COLUMBIA OIL & GAS CO., 118 Fed. (2d) 459 (Fifth Circuit), affirming 41 B.T.A. 38; CULLEN v. COMMISSIONER, supra (Fifth Circuit); and THOMAS v. PECKHAM, 115 Fed. (2d) 685 (Fifth Circuit).

There is no decision of any court which holds to the contrary. And, as previously stated herein, the Fifth Circuit in COMMISSIONER v. HOGAN, supra, held that the cost of the equipment is deductible from the cash consideration even though the retention is in the form of an overriding royalty. Since, as shown above, there is no difference between an oil payment and overriding royalty, the rule applied by the courts in cases where an oil payment is retained should also be applied if the retained interest is in the form of an override, if, as here, the vendor does not retain any interest in the equipment.

An oil and gas lease and the equipment thereon are, for income tax purposes, different classes of property. One is depletable; the other depreciable. The cost of each is recoverable by different processes. The cost of the equipment may not be transformed into the cost of the leasehold and recovered through depletion.

6. The Commissioner, in the court below, stated that the CULLEN case, which, as previously stated, was later repudiated and reversed by the Fifth Circuit Court in COMMISSIONER v. HOGAN, supra, presented identical facts and should be followed, and contended that when the lease was "leased" to Sylva, the partnership's investment in both lease and equipment "merged" and became cost to it of the retained royalty interest, which cost is returnable through depletion. The court below does not appear to have given any weight to such argument, but in the event the respondent reiterates the argument in this Court, we wish to point out that since the inception of the income tax laws an oil and gas lease and the equipment on the lease have been treated as separate and distinct units of property, the cost of the former being returnable only through depletion allowances and that of the latter only through annual deductions for depreciation. This long-standing treatment accorded to the two distinct units of property alone would seem to be sufficient to refute the contention that the cost of the units could under any circumstances be said to merge, and the cost of one type of property be substituted for or become that of another type. See in this connection the decision of this court in DAKOTA-MONTANA OIL CO. v. U. S., 288 U.S. 459, 53 S. Ct. 435, where the court held that the intangible costs of drilling the hole in the ground is recoverable only through depletion allowances and may not be recovered by way of deductions

for depreciation. It would seem to logically follow from this decision that the reverse would also be true and that the cost of depreciable property cannot be recovered through depletion allowances but can only be recovered through allowances for depreciation.

A merger is said to contemplate the absorption of a lesser interest by a greater, as where a life tenant acquires the fee. The partnership did not acquire any interest to merge with or be absorbed by the 1/8th royalty interest which it retained in the sale to Sylva. Just the opposite is true. The partnership parted with all of its property except the 1/8th royalty, and we fail to see how it could be said that there could have been a merger of the cost of the equipment with the cost of the retained interest.

Moreover, while it is possible for costs of property to be combined or merged for income tax purposes, as where the owner of a one-half interest in an oil and gas lease buys the other half, in which event the cost of each half might be said to combine or merge for cost depletion purposes, it is not possible for the cost of one kind of property to be combined with the cost of another and different kind of property where the cost of each is recoverable through different processes and under different provisions of the law and regulations. As previously pointed out herein, the owner of an oil and gas lease has always been required to recover the cost of his lease through depletion allowances and the cost of his lease equipment through depreciation allowances, and there is no provision which will permit the transformation of the cost of the equipment into the cost of the leasehold and allow the cost of the equipment to be recovered through depletion.

If, in the illustration given above, the taxpayer had acquired the other half interest in the lease equipment in addition to the other half interest in the lease, he would not be permitted under the present law and regulations to charge

what he paid for the half interest in the equipment to his leasehold cost and recover same through depletion allowances. Nor would he be permitted to charge the cost of the other half interest in the lease to the cost of the equipment and recover it through depreciation allowances. This is so because, as previously stated, for income tax purposes the leasehold and the equipment are classified and treated as separate and distinct units of property, the cost of each being recoverable through different and distinct methods.

It seems clear, therefore, that under no circumstances can the cost of the equipment be combined with the cost of the leasehold and recovered through depletion allowances; therefore, there is no merit to the merger contention if respondent sees fit to again advance it in this proceeding.

The partnership sold the equipment outright. It retained no interest or lien of any kind. The Commissioner recognized that ownership of the equipment was in Sylva because he allowed that Company to take depreciation on it. The undepreciated cost of the equipment is therefore deductible from the consideration in computing the gain on the transaction.

7. By the terms of the assignment, the partnership sold an interest in the oil reserves, reserved an overriding royalty of 1/8th of 8 8ths of production, and sold the lease and well equipment outright. The partnership did not retain title, lien, or any kindred interest in the equipment, either expressly or by implication. The partnership completely divested itself of all of its interest in the equipment. After the transaction was completed, the Sylva Oil Company was the owner of all of the equipment. The respondent recognized that ownership was in Sylva because The Tax Court found as a fact (R. 18) that he allowed Sylva to deduct depreciation of $1,674.17 for 1938 and $5,613.35 for the year 1939 after an examination by his agent. Depreciation is allowable only to the owner of the property on which it is claimed. Since it is clear that the partnership disposed of its entire interest in the equipment, the undepreciated cost ($23,090.60) is deductible from the cash consideration of $110,000. Unless the cost is so deducted, the true gain on the transaction will not be reflected and the cost of the equipment will never be returned to the members of the partnership.

Conclusion

The decision of the Circuit Court of Appeals for the Tenth Circuit should be reversed.

Respectfully submitted,

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Appendix

SEC. 114 REVENUE ACT OF 1938:

(b) (3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under Section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23 (m) be less than it would be if computed without reference to this paragraph.

REGULATIONS 101, ART. 23:

(m)-1 (g). "Gross income from the property, as used in Section 114 (b) (3) and (4) and Articles 23 (m)-1 to 23 (m)-28, inclusive, means the amount for which the taxpayer sells (a) the crude mineral product of the property or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade from which the product sold was derived, before the application of any processes (to which the crude mineral product may have been subjected after emerging from the mine or well) with the exception of those listed below, and before transportation from the place where the last of the processes listed below was applied. If there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes minus the costs (including transportation costs) of the processes not listed below. * * *

SEC. 114, REVENUE ACT OF 1938:

(b) (1) Basis for Depletion. The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in Paragraphs (2), (3), and (4) of this subsection.

SEC. 113, REVENUE ACT OF 1938:

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * *

(14) Property Acquired Before March 1, 1913.—In the case of property acquired before March 1, 1913, if the basis otherwise determined under this subsection, adjusted (for the period prior to March 1, 1913) as provided in Subsection (b), is less than the fair market value of the property as of March 1, 1913, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

REGULATIONS 101, ART. 23:

(m)-2. Computation of depletion of mines, oil and gas wells, and other natural deposits without reference to discovery value or percentage depletion.—The basis upon which depletion, other than discovery depletion or percentage depletion, is to be allowed in respect of any property is the basis provided in Section 113 (a), adjusted as provided in Section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property. (See Articles 113 (a)-1 to 114-1.) If the amount of the basis as adjusted applicable

to the mineral deposit has been determined for the taxable year, the depletion for that year shall be computed by dividing that amount by the number of units of mineral remaining as of the taxable year, and by multiplying the depletion unit, so determined, by the number of units of mineral sold within the taxable year. In the selection of a unit of mineral for depletion, preference shall be given to the principal or customary unit or units paid for in the products sold, such as tons of ore, barrels of oil, or thousands of cubic feet of natural gas. * * *

REGULATIONS 101, ART. 23:

(m)-16. Charges to capital and to expense in the case of oil and gas wells.—(a) Items chargeable to capital or to expense at taxpayer's option:

(1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc. incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and

developing items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells at the option of the taxpayer may be deducted from gross income for the year in which the taxpayer completes such a well or be charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) If deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or if capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(b) Recovery of option items, if capitalized:

(1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article the expenditures for clearing ground, drainage, road making, surveying, geological work,

excavation, grading, and the drilling, shooting, and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. Such expenditures are amounts paid for wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

SEC. 111, REVENUE ACT OF 1938:

(a) COMPUTATION OF GAIN OR LOSS—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

SEC. 23. REVENUE ACT OF 1938:

(In computing net income there shall be allowed as deductions):

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

REGULATIONS 101, ART. 23:

(m)-18. Depreciation of improvements in the case of oil and gas wells.—Both owners and lessees operating oil or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under Article 23(m)-16. * * *

(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Fred T. Hogan, Petitioner, v. Commissioner of Internal Revenue, Respondent. Commissioner of Internal Revenue, Petitioner, v. Fred T. Hogan, Respondent.

United States Circuit Court of Appeals for the Fifth Circuit. No. 10749. February 25, 1944.

Petitions for review of decision of the Tax Court of the United States (District of Texas).

Before Holmes, Waller, and Lee, Circuit Judges.

Lee, Circuit Judge: This case comes to us on separate petitions of Fred T. Hogan, the taxpayer, and the Commissioner of Internal Revenue for a review of a decision of the Tax Court. Both causes were consolidated upon joint motion for

printing the record, briefing, argument and decision. The questions presented for determination are:

1. Was the transfer by Choate & Hogan, a partnership of which taxpayer was a member, of an interest in a producing oil and gas lease and all equipment thereon, for cash and the reservation of an overriding royalty, a sale resulting in a capital gain taxable under Section 117 of the Revenue Act of 1938[1] or a sublease resulting in ordinary income under Section 22(a) of the Act?

2. Did title to the leasehold equipment pass with the interest in the lease; if so, was the depreciated cost deductible from the cash consideration paid?

[*The Facts*]

The facts out of which this litigation grew are as follows: Mrs. M. L. Baker executed, on September 8, 1924, an oil and gas lease in favor of G. A. Tunstill, covering approximately 1250 acres of land situated in Upton County, Texas. The lease provided for the usual one-eighth (1/8) royalty of oil, for one-eighth (1/8) of the value of casinghead gas utilized and for $200 per annum for each gas well from which gas was used off the premises or marketed by lessee. Fred T. Hogan and L. H. Choate, acting for themselves and W. G. Choate, acquired 230 acres of this lease on December 18, 1936, as to all rights thereunder and incident thereto down to the depth of 2750 feet, by mesne assignments out of G. A. Tunstill, the original lessee, subject to one-sixteenth (1/16) overriding royalty in favor of the Continental Oil Company.[2] Hogan and the two Choates

[1] 52 Stat. 447.

[2] On July 7, 1925, Tunstill assigned the lease except as to certain acreage to Marland Oil Company and as a result of the consolidation

formed a partnership under the name of Choate & Hogan, for the purpose of owning, developing, and operating the lease, the profits and losses of said partnership in keeping with the ownership of the lease, to be shared 50% by Hogan and 50% by L. H. Choate and W. G. Choate. The partnership owned and operated the property until August 22, 1938, drilling and completing thereon six producing oil wells. On August 11, 1938, the partnership entered into a contract with McAlester Fuel Company pursuant to which Fred T. Hogan and L. H. Choate, on August 22, 1938, at the request of McAlester Fuel Company, executed, and, upon payment of $110,000, delivered to Sylva Oil Company an assignment reading in part as follows:

> "The undersigned L. H. Choate and Fred T. Hogan, the present owners of said lease * * * do hereby bargain, sell, assign and convey subject to * * * the reservation of 1/16 overriding royalty in said assignment from the Continental Oil Company to Roy R. Brown, all rights, title and interest to the original lessee and the present owner in and to said lease, and rights thereunder or incident thereto, * * * at and above the depth of two thousand seven hundred fifty feet from the surface in and under the said 230 acres of land above

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of that Company with the Continental Oil Company on July 1, 1929, the lease became the property of the Continental Oil Company. On December 3, 1936, Continental Oil Company assigned to Roy R. Brown all of its rights, titles and interest in the lease "so far as said lease covers and affects the oil, gas and casinghead gas, and the oil, gas and casinghead gas rights, at and above the depth of 2750 feet from the surface," as to 230 acres specifically described. Brown agreed in this assignment that "as a part of the consideration * * *, the assignor shall receive, as an overriding royalty, one-sixteenth (1/16) of all the oil, gas and casinghead gas produced, saved and sold" from the assigned premises. On December 18, 1936, Brown conveyed the interest so acquired subject to the terms and conditions of his assignment from the Continental Oil Company to Fred T. Hogan and L. H. Choate.

described, together with all wells and equipment thereof, including pumps, casing, piping, tanks, lease house, and all other personal property on or used in connection with said premises, including oil in storage, to Sylva Oil Company, a Texas corporation, its successors and assigns; save and except that assignors herein expressly reserve to themselves, their heirs and assigns and do not assign or convey to assignee herein 1/8th of 8/8ths of all oil and gas and casinghead gas which may be produced and saved by Sylva Oil Company, its successors and assigns, from the aforesaid land at and above the depth of two thousand seven hundred fifty feet from the surface * * *; such reservation of overriding royalty or share of production to be 1/16th of 8/8ths in favor of L. H. Choate and 1/16th of 8/8ths in favor of Fred T. Hogan. * * * "

The partnership in its return for 1938 allocated $98,454.70 of the cash consideration to the leasehold and the remainder of $11,545.30 to the equipment. It treated the net gain from the transfer of the leasehold of $71,870.92 as a long-term capital gain, taxable to the extent of $47,913.95, and the net loss from the transfer of the equipment of $11,545.30 as an ordinary loss. This gain and loss was divided among the partners in the following proportions:

		Gain	Loss
Fred T. Hogan	1/2	$23,956.98	$ 5,772.65
L. H. Choate	1/8	5,989.24	1,443.16
Lucille Choate	1/8	5,989.24	1,443.16
W. G. Choate	1/4	11,978.49	2,836.33
		$47,913.95	$11,545.30

The Commissioner refused to recognize the assignment as a sale, contending that it was a sublease and that the con-

sideration of $110,000 was a bonus, and computed the gain on the transaction as follows:

"Oil Income"		$110,000.00
Less—Depletion	$30,250.00	
Commissions	3,000.00	33,250.00
Net Income		$ 76,750.00

The Tax Court held: (1) That the partnership was not entitled to treat the assignment as a sale, but must look to depletion for the return of its capital. (2) That title to the equipment passed to Sylva Oil Company under the assignment and the partnership was entitled to an allowance for the unrecovered cost of said equipment. The taxpayer petitions for review of the first holding. The Commissioner petitions for review of the second holding. We shall consider separately the questions presented.

1. The assignment and transfer of a producing oil and gas lease for cash and a reservation of an overriding royalty in some states is the sale of the oil and gas in place, and in others, a sublease. The assignment, therefore, in the present case would be a sale in some states and a sublease in others, dependent upon local law. In applying the income tax statute, however, the Supreme Court has held that technical distinctions of local laws will be disregarded, and the statute will be interpreted so as to apply uniformly.

[*Sublease v. Sale*]

When the owner and operator of a producing oil and gas lease assigns and transfers it for cash and the payment of an overriding royalty, he retains an economic interest in the oil and gas in place which will be depleted by production.

The cash bonus received by him is treated as advance royalty with the same tax incidence. The granting clause in such an assignment is oftentimes written in language used in a sale, and standing alone would effect a sale; but where the granting clause conveys all of the rights of the assignor and is qualified by other parts, parts for instance, reserving in the assignor an overriding royalty, the assignment, for income tax purposes, partakes of the nature of a sublease rather than of a sale and is of the character of transaction with respect to which relief is granted in the Act by the allowance of depletions.

[*Harmel Case Discussed*]

In the case of Burnet v. Harmel, 287 U.S. 103 [3 USTC Par. 990], the Supreme Court, discussing the Texas law which treats an oil and gas lease as a sale of minerals in place, pointed out that nevertheless such a document was a lease instead of a sale within the ordinary conception of the word as used in the "Capital Gains" section of the Revenue Act of 1924, and said (page 106):

It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act. Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time-consuming operation and the payments made by the lessee

to the lessor do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property. The payment of an initial bonus alters the character of the transaction no more than an unusually large rental for the first year alters the character of any other lease, and the taxation of the one as ordinary income does not act as a deterrent upon conversion of capital assets, any more than the taxation of the other.

We agree with the Tax Court that the partnership was not entitled to treat the assignment as a sale of a capital asset, but must look to depletion for the return of its capital.

2. We also agree with the Tax Court that title to the equipment passed from the partnership to Sylva Oil Company under the assignment, and that the partnership was entitled to deduct from the cash consideration the depreciated cost of said equipment. The assignment conveyed to Sylva Oil Company not only an interest in a producing oil and gas lease, but all equipment thereon. Under the Act, depletion percentage on the bonus received and the royalty reserved is not a deduction associated with equipment cost. Equipment cost is recoverable through depreciation allowances and not "by percentage depletion allowances," as apparently was inadvertently stated in *Cullen v. Commissioner*.[8] It is only with respect to wasting assets that depletion allowances are made.[9] * * *

We find no error in the opinion and decree of the Tax Court. Its holding is, therefore, affirmed.

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[8] 118 F. (2d) 651, 653 (41-1 USTC, Par. 9364).

[9] 26 U. S. C. A. 23(m).